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Certified Hedge Fund Manager

Sample Material

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V-Skills

Skills for a secure future

Like mutual funds, hedge funds pool investors' money and invest the money in an effort to make a positive return. Hedge funds typically have more flexible investment strategies than mutual funds. Many hedge funds seek to profit in all kinds of markets by using leverage (in other words, borrowing to increase investment exposure as well as risk), short-selling and other speculative investment practices that are not often used by mutual funds.

One way of defining a hedge fund is by comparing the similarities and differences with mutual funds.

- ✓ The key difference between hedge funds and mutual funds lies in the degree of regulation, the level and variety of risky investment strategies. Whereas mutual funds are required to adhere to strict financial regulations, including the types and levels of risks, hedge funds are free to pursue virtually any investment strategy with any level of risk.
- ✓ Hedge fund investors are typically high net worth individuals or institutional investors like pension funds, partly because hedge funds typically require high minimum investment amounts. Mutual funds on the other hand, are typically targeted at the general public and will accept any investor who can meet the minimum investment amount. Hedge funds are banned from advertising and in some cases the investors are required to be "accredited".
- ✓ Another difference is the fund portfolio composition. Most mutual funds are composed of equities and bonds. Hedge fund portfolio compositions are far more varied, with possibly a significant weighting in non-equity/bond assets e.g. derivatives.
- ✓ The historical return characteristics and distribution of hedge funds tend to differ significantly from mutual funds. For example, Capocci et al. and Getmansky demonstrate that hedge funds empirically display serial correlation in returns. Hedge funds do not perform significantly better than most investment funds.

Unlike mutual funds, hedge funds are not subject to some of the regulations that are designed to protect investors. Depending on the amount of assets in the hedge funds advised by a manager, some hedge fund managers may not be required to register or to file public reports with the SEC. Hedge funds, however, are subject to the same prohibitions against fraud as are other market participants, and their managers owe a fiduciary duty to the funds that they manage.

The nomenclature "hedge fund" provides insight into its original definition. To "hedge" is to lower overall risk by taking on an asset position that offsets an existing source of risk. For instance, if an investor is holding a large position in foreign equities, he/she can hedge the portfolio's currency risk by going short currency futures. A trader with a large inventory position in an individual stock can hedge the market component of the stock's risk by going short equity index futures. Hedge fund may be seen as an information motivated fund that hedges most sources of risk not related to the price-relevant information available for speculation.

Speculation is any action, with some non-zero risk, made in order to make a profit. This classic definition of speculation also includes the careful research of undervalued securities for long-term gain i.e. investing. In informal contexts, the word speculation has acquired the implicit meaning of actions based on inconclusive evidence and the desire for short-term, high-risk profit.

Theoretically, a hedge fund can be characterized as the "purely active" component of a traditional actively-managed portfolio whose performance is measured against a market benchmark. Consider the following equation.

$$\mathbf{h = w - b}$$

Where,

w = the portfolio weights of the traditional actively-managed equity portfolio

b = the market benchmark weights for the passive index used to gauge the performance of a fund

h= the active weights. That is, the differences between the portfolio weights and the benchmark weights

A traditional fund has no short positions, hence w has all positive (not negative) weights; most market benchmarks also have all positive weights. Therefore, w and b are positive in all components except the h, has an equal percentage of short positions as long positions. Theoretically, one can take portfolio h as a hedge fund implied by the traditional active portfolio w.

The following two strategies are equivalent.

- ✓ Hold the traditional actively-managed portfolio w
- ✓ Hold the passive index b plus invest in the hedge fund h.

Defined in this way, hedge funds are a device to separate the "purely active" investment portfolio h from the "purely passive" portfolio b. The traditional active portfolio w combines the two components.

The above theoretical hedge fund is not implement able in reality as short positions require margin cash. The hedge fund above has zero net investment and for that reason there is no cash available for margin accounts. If the benchmark includes a positive cash weight, this can be redirected to the hedge fund. Then the hedge fund will have a positive overall weight, consisting of a net-zero investment (long and short) in equities, plus a positive position in cash to cover margin.

The operational composition of hedge funds has steadily evolved until it is now difficult to define a hedge fund based upon investment strategies alone. Hedge funds now vary widely in investing strategies, size, and other characteristics.

1.2 Hedge Funds Vs. Traditional Funds

Though hedge funds have many commonalities as other investment vehicles such as return motive, market orientation, risk, fees etc., it differs in various ways from the traditional funds such as mutual funds or pension funds. In addition to the differences already stated above, below are more characteristics of hedge funds that make them stand apart.

- ✓ **Investment Structure:** The investment structure of hedge funds gives great control and flexibility to the general partner of the hedge fund. Traditional equity management on the other hand gives the individual investor greater control and access to the portfolio information, regulatory protection and liquidity.
- ✓ **Capacity Constrains:** Hedge Funds being largely unregulated give the fund much flexibility to tap on opportunities but they have constraints as to the extent of their marketing efforts, communication to clients etc. Many hedge funds do close once a certain asset size has been achieved for returns to remain attractive to investors.
- ✓ **Transparency of Portfolio:** Hedge funds offer very little transparency compared to traditional assets. Many hedge fund managers are reluctant to do so partially to keep their 'trade secrets' within themselves for the fear of competition. However, many hedge funds now do provide monthly performance statements with rations like sharp ratios, beta & alpha etc.

- ✓ **Risk:** Hedge funds are viewed as higher risk than traditional asset management due to leveraging & shorting. However, shorting can be viewed as a risk management tool during periods of market declines between 2000-2002.

1.3 Brief History of the Hedge Funds Industry

The first hedge fund that ever formed was by Albert Winslow Jones in 1949, as the main investment strategy was to take hedged equity investments. By 'hedging' -the act of removing risk in some investment by taking an investment in another investment- Winslow was able to eliminate a certain amount of market risk. Remarkably many of the ideas that he introduced over fifty years ago remain fundamental to today's hedge fund industry.

Jones structured his fund to be exempt from the SEC regulations described in the Investment Company Act of 1940. This enabled Jones' fund to use a wider variety of investment techniques, including short selling, leverage, and concentration (rather than diversification) of his portfolio. Jones committed his own money in the partnership and based his remuneration as a performance incentive fee, 20% of profits. Both practices encourage interest alignment between manager and outside investor and continue to be used today by most hedge funds.

Jones was the first to combine shorting and leverage techniques that give exposure to risk, and used them to instead hedge against market movements and reduce his risk exposure. He was an excellent stock picker, but a poor market timer. That is why he was comfortable with a market-neutral strategy of having equal long and short positions. Jones' long-short strategy rewarded exceptional stock selection and created a portfolio that reacted less to the vagaries of the overall market. He also used the capital made available from short selling as leverage to make additional investments. Jones went on to also hire other managers and delegated authority for portions of the fund, and thus initiated the multi-manager hedge fund. The multi-manager approach later evolved into the first fund of hedge funds.

Hedge funds soon grew to become well-known after an article in Fortune Magazine in 1966 that mentioned Jones's fund and its significant out performance against other Mutual Funds. In the mid-1960s, Jones' fund was still active and began to inspire imitations, some from investment managers who once worked for Jones. An SEC report documented 140 live hedge funds in 1968. This article temporarily intrigued investors about hedge funds but the popularity faded as investors fell victim to the bear markets of 1969-70 and 1973-4. During the bear market, the S&P 500 declined by a third. Funds with leveraged long-bias strategies were damaged because of insufficient risk reduction techniques. As a result, many hedge funds went out of business, and hedge funds decreased in popularity for the next 10 years.

A decade later (1986), Robertson's infamous Tiger Fund once again caught people's interest in hedge funds. The Tiger Fund was one of several so-called global macro funds that made leveraged investments in securities and currencies, based upon assessments of global macroeconomic and political conditions. This fund achieved compound annual returns of 43% for 6 years after all expenses. Robertson's Fund had a huge impact on the publicity of the hedge fund industry by showing the rapid expansion of hedge funds for more than 10 years until 1997. Hedge funds became admired for their profitability, and reviled for their seeming destabilising influence on world financial markets.

In 1992 during the European Exchange Rate Mechanism crisis, George Soros' Quantum Fund, another global macro hedge fund, made over a billion dollars from shorting the British pound. During the "Asian Contagion" currency crisis in July 1997, the Thai Baht fell 23%. Quantum Fund had shorted the Baht and gained 11.4% that month. Similar success stories increased the appeal and fascination associated with hedge funds, but also established a reputation for benefiting from and contributing to financial market chaos.

As the number of hedge funds grew, a multitude of new hedge fund trading strategies evolved along with it which included the use of derivatives. Many investors were using investment strategies beyond simply hedging. To complicate matters, as hedge fund strategies developed, so did the strategies of other types of funds. Other funds started using Winslow's equity hedging strategy too. Thus hedging was no longer unique to hedge funds.

Today, the word "hedge" in hedge funds has become a misnomer, more of a historical context that came from Alfred Winslow rather than a pertinent description.
While high net worth individuals remain the main source of capital, hedge funds are becoming more popular among institutional and retail investors. Funds of funds and other hedge fund-linked products are increasingly being marketed to the retail investors in some jurisdictions.

All together, there are a number of factors behind the rising demand for hedge funds.

The exceptional bull run in the US equity markets during the 90s increased investment portfolios. This lead both, fund managers and investors, to become more strongly aware of the significance of diversification. Hedge funds are seen as a natural “hedge” for controlling downside risk because they use exotic investments strategies expected to generate returns that are uncorrelated to asset classes.

Until recently, the wave of scandals that hit corporate America and the uncertainties in the US economy has lead to a general decline in the stock markets worldwide. This provided fresh momentum for hedge funds as investors searched for absolute returns.

The growth in demand for hedge fund products has brought changes on the supply side of the market. The prospect of potential riches has encouraged many former fund managers and proprietary trades to strike out on their own and set up new hedge funds. With hedge funds entering the main stream and becoming ‘respectable’, an increasing number of banks, insurance companies, pension funds, are investing in them.

1.4 Hedge Funds in India

With the notification of SEBI (Mutual Fund) Regulations 1993, the asset management business under private sector took its root in India. SEBI notified Regulations and Rules governing Portfolio Managers who pursuant to a contract or arrangement with clients, advise clients or undertake the management of portfolio of securities or funds of the client. There is no information about any hedge funds domiciled in India. Further, on account of limited convertibility, offshore hedge funds have yet to offer their products to Indian investors within India.

Recently, RBI through liberalized remittance scheme, allowed resident individuals to remit up to US $ 25,000 per year for any current or capital account transaction. The liberalized scheme will allow Indian individual investors to explore the possibility of investing in offshore financial products. Considering the existing limit being only US $ 25,000 per year, Indian market may not be attractive to hedge fund product marketing. As long as there will be restriction on capital account convertibility, foreign hedge funds, by virtue of their minimum investment limit being $100,000 or higher, do not seem to be excited to access investment from Indian investors in India.

Some hedge funds have invested in offshore derivative instruments (PNs) issued by FIIs against underlying Indian securities. Through this route hedge funds can derive economic benefit of investing in Indian securities without directly entering the Indian market as FIIs or their sub-accounts.

Through recent amendments to the FII Regulations, the regulatory regime has been further strengthened and periodic disclosures regime has been introduced. In the offshore derivative instruments (PNs) against Indian equity, are Rs. 8050 crores which represent about 8% total net equity investments of all FIIs. On the basis of market value, the hedge funds account for about 5% of the market value of the total assets held by the FIIs in India.

In this context, the following approach may be considered for allowing the well-established hedge funds to invest in Indian markets as a registered entity under the SEBI (Foreign Institutional Investors) Regulations, 1995.

List of Hedge Funds in India.

- ✓ HFG India Continuum Fund
- ✓ Avatar Investment Management
- ✓ India Deep Value Fund
- ✓ Fair Value Capital
- ✓ Indea Capital Pte. Ltd
- ✓ India Capital FundSM
- ✓ Monsoon Capital Equity Value Fund
- ✓ Karma Capital Management, LLC
- ✓ Atyant Capital
- ✓ Atlantis India Opportunities Fund